Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Nation | Analyst: John Pavalasky | Bill Number: AB 198

Related Bills: See Prior Analysis | Telephone: 845-4335 | Amended Date: August 5, 2004

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Depreciation Deduction/No Deduction Allowed For Luxury Heavy Vehicle/Qualified Tuition And Fees Credit

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended __________________________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended __________________________.

__X__ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO __________________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED August 18, 2003, STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would deny the general California business income and franchise tax incentives relating to vehicles when a business purchases a luxury heavy vehicle (LHV). The revenue from disallowing these incentives would be used to fund a credit for qualified tuition and fees imposed by the California State University (CSU) or the University of California (UC) and paid by a qualified taxpayer, as defined.

SUMMARY OF AMENDMENTS

The August 5, 2004, amendments would change the effective dates of the credit and deduction denial to apply to taxable years beginning on or after January 1, 2005, and before January 1, 2009. In addition, the bill is modified to:

- Strikeout the credit for the purchase and use of qualified reduced-emission vehicles.
- Allow a credit for qualified tuition and fees imposed by the CSU or the UC and paid by a qualified taxpayer, as defined.
- Strikeout the exceptions to the denial of business deductions for farming businesses, timber businesses, and construction businesses.

An analysis of the new credit and the deduction denial is provided to reflect the August 5, 2004, amendments. In addition, a new revenue estimate is provided. Except for the EFFECTIVE/ OPERATIVE DATE, the remainder of the analysis of the bill as amended August 18, 2003, still applies and is not repeated.

Board Position:			Legislative Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Brian Putler	8/10/04
_____ N	_____ OUA	__X__ PENDING		

EFFECTIVE/OPERATIVE DATE

As amended August 5, 2004, this bill, as a tax levy, would be effective immediately. However, this bill provides that the credit would apply to taxable years beginning on or after January 1, 2005, and before January 1, 2009, and the business incentive disallowance would apply to property placed in service on or after January 1, 2005, and before January 1, 2009.

POSITION

Pending.

Suggested Technical Amendments

Technical amendments relating to the August 5, 2004, amendments are needed as follows:
On page 2, lines 6 and 7, strikeout “twenty-five thousand dollars ($25,000)” and insert “one hundred thousand dollars ($100,000)” to reflect the amount currently allowed to be deducted on the federal return. On page 3, line 39, strikeout “of the board” at the end of that line. This technical amendment would strikeout an unnecessary phrase and would insure that the term “board” used in this section would not be misconstrued to refer to the State Board of Equalization, which that term under the Revenue and Taxation Code would otherwise mean.

ANALYSIS

The August 5, 2004, amendments to the deduction denial provisions are discussed separately from the amendments that would create a new credit.

1. Eliminate Deductions For Large Luxury SUV

FEDERAL/STATE LAW

Current Federal Law

Under federal law a corporate or noncorporate taxpayer (other than estates, trusts, or certain noncorporate lessors) may elect to treat the cost of qualifying property (called Section 179 property) as a current expense rather than being required to depreciate the property over a number of years. The Jobs And Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 increased the maximum deduction for 2003, 2004, and 2005 from $25,000 to $100,000.

This maximum deduction is reduced, on a dollar for dollar basis, once assets costing more than $400,000 (increased from $200,000 by JGTRRA) have been placed in service by the taxpayer during the taxable year. This reduction is the mechanism used to target the benefit to small businesses.

Federal law also contains rules (called the luxury car limits) that limit the amount of depreciation or Section 179 expensing that can be deducted each year for certain passenger vehicles. These luxury car limits apply to leases of passenger vehicles by requiring an amount to be added to income in each year of the lease (using tables issued by the Internal Revenue Service) based on the fair market value of the vehicle for that year. For purposes of the luxury car limits, a passenger vehicle is any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways that has an *unloaded* gross vehicle weight (i.e., curb weight fully equipped for service but without passengers or cargo) of 6,000 pounds or less. However, a passenger vehicle includes a truck or van (including a SUV or minivan) if it has a gross vehicle weight (i.e., maximum total weight of a *loaded* vehicle as specified by the manufacturer) of 6,000 pounds or less. Consequently, some LHVs are not subject to the luxury car limits.

Current State Law

California is conformed, in general, to the federal Section 179 deduction and the luxury car limits for noncorporate taxpayers and S corporations, with the following differences:

- For non-corporate taxpayers, the maximum deduction for 2003 and later years is $25,000.
- This maximum deduction is reduced, on a dollar for dollar basis, once assets costing more than $200,000 have been placed in service by the taxpayer during the taxable year.

For corporations, the maximum expensing deduction is $2,000. Also, the depreciable lives of corporate assets vary by type of asset but, in general, are longer than the depreciation period under federal law.

In addition, California allows a business operating in the following economic development areas, in lieu of the Section 179 deduction, to deduct currently as an expense (rather than depreciate) a larger portion of a depreciable asset (defined by reference to Section 1245(a)(3) of the Internal Revenue Code):

- Enterprise Zones (EZ's),
- Local Agency Military Base Recovery Areas (LAMBRA's), and
- Targeted Tax Area (TTA).

THIS BILL

With respect to LHVs, as defined, placed in service in 2005 and later, this bill would deny depreciation deductions as well as small business expense deductions (including those pertaining to enterprise zones (EZ), local area military base recovery areas (LAMBRA), and targeted tax areas (TTA)) to the owners of these vehicles.

Thus, if a taxpayer purchases a LHV, or the taxpayer leases the LHV under a finance lease (i.e., the taxpayer and not the leasing company is treated as the owner of the vehicle), that taxpayer would be denied depreciation deductions as well as small business expense deductions with respect to that vehicle. In addition, if the taxpayer leases a LHV under an operating lease (i.e., the leasing company is treated as the owner of the vehicle), the leasing company would be denied depreciation deductions as well as small business expense deductions with respect to any LHVs that are leased to others. In addition, a taxpayer with an operating lease would be denied the business expense for the lease payments.

This bill, as amended August 5, 2004, no longer exempts agricultural, timber, and construction businesses from the deduction denials.

This bill would define a LHV as a four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways if the vehicle meets all of the following requirements:

(1) Is rated between 6,000 and 14,000 pounds gross vehicle weight,
(2) Is designed to seat nine or fewer individuals, and
(3) Is not equipped with an open cargo area with an interior length of 72 or more inches or does not have a covered box with an interior length of 72 or more inches that is separate from the passenger compartment.

2. Credit For Qualified Tuition And Fees Imposed By The CSU or The UC And Paid By A Qualified Taxpayer

FEDERAL/STATE LAW

Current federal law

An individual taxpayer may claim an income tax credit for the Hope Scholarship Credit (maximum of $1,500 per year for each eligible student) and the Lifetime Learning Credit (maximum $2,000 per return) for higher education expenses at accredited post-secondary educational institutions paid for themselves, their spouses, and their dependents. The Hope Credit is available only for qualified expenses of the first two years of undergraduate education while the Lifetime Learning Credit is available for qualified expenses of any post-high school education at "eligible educational institutions." Both credits cannot be claimed in the same taxable year for expenses of any one student, and are phased out for higher-income taxpayers. For 2004, the phase out ranges are $42,000 to $52,000 for single persons and $85,000 to $105,000 for married taxpayers filing a joint return. Married taxpayers must file joint returns to claim these credits.

Qualified tuition and related expenses for purposes of these credits means tuition and fees required for the enrollment or attendance of the taxpayer, his spouse, or dependent, at a post-secondary educational institution eligible to participate in the federal student loan program.

Student activity fees and fees for course-related books, supplies, and equipment qualify for these credits only if they must be paid directly to the educational institution for the enrollment or attendance of the student. Room and board, insurance, transportation, or other similar personal, living, or family expenses are not eligible expenses, whether or not paid to an educational institution.

The cost of any course of instruction at an eligible institution taken to acquire or improve job skills qualifies for the Lifetime Learning Credit, but not the Hope Credit, even if it involves sports, games, hobbies, or is a noncredit course.

Current state law

California has not conformed to either of these two federal credits.

THIS BILL

As amended August 5, 2004, this bill would allow a nonrefundable credit in taxable years 2005 through 2008. The credit would be 2% of the cost paid or incurred by a qualified taxpayer, as defined, during the taxable year for qualified tuition and fees.

A "qualified taxpayer" is defined as a taxpayer whose adjusted gross income (AGI) for the taxable year is $50,000 or less ($100,000 or less in the case of a married couple filing a joint return).

"Qualified tuition and fees" is defined as the tuition and fees imposed by the CSU or the UC for enrollment as a student in courses at those universities by the following:

- The qualified taxpayer.
- The qualified taxpayer's spouse.
- Any dependent of the qualified taxpayer.

"Qualified tuition and fees" specifically do not include any of the following:

- Tuition or fees for any course involving sports, games, or hobbies, unless the course is a prerequisite for obtaining the degree sought by the student.
- Any student activity fees, athletic fees, insurance expenses, or any other fees or expenses that are not related to the student's degree program.
- Tuition and fees paid or incurred by or on behalf of any student who is not carrying a course load of at least one-half of the normal course load required for completion of the degree sought by the student.

A qualified taxpayer is required to retain evidence of the cost paid or incurred for qualified tuition and fees and to provide that evidence to the Franchise Tax Board upon request.

This bill limits the total aggregate amount of credits allowed to all qualified taxpayers for each taxable year to the amount of the increase in state tax for that taxable year pursuant to the denial of business deductions for LHVs.

If the credit allowed exceeds the taxpayer's net tax for that year, the excess is carried over and applied to reduce the taxpayer's net tax in the following eight years, if necessary, until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

This bill limits the total aggregate amount of credits allowed to all qualified taxpayers for each taxable year to the amount of the increase in state tax for that taxable year pursuant to the denial of business deductions for LHVs. However, the bill does not provide the method to accomplish this aggregate limitation. One method would be for the credits to be allowed on a first-come; first-served basis. This method would require the monitoring of the amounts claimed on returns as they are filed and to deny the credits for those claimed on returns filed after the aggregate limit had been reached for the taxable year. Unspecified methods of limitation could lead to disputes with taxpayers and would complicate the administration of this credit. Those denied credits would not be eligible for carryover under the bill as only credits allowed that exceed the net tax are allowed to be carried over.

Typically, credits involving areas for which the department does not possess expertise (such as qualified educational expenses) are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer.

If the CSU and UC were, using a method of centralized coordination, required to provide credit certificates (not to exceed the estimated increase in tax pursuant to the business expense denial for LHVs) to qualified taxpayers, all of these implementation considerations would be resolved.

FISCAL IMPACT

If this bill were amended to resolve the implementation considerations, implementing this bill would be accomplished during the normal annual update.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the following table reflects the estimated impact of this bill:

Revenue Impact of AB198 as Amended August 5, 2004 For Taxable Years Beginning On Or After 1/1/2005 Fiscal Years (In Millions)				
	2004-05	2005-06	2006-07	2007-08
Luxury Heavy Vehicle Deductions	+$5	+$20	+$35	+$25
Applied Tuition Credits	$0	-$20	-$25	-$25
Revenue Impact	+$5	$0	+$10	$0

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The impact of this bill would depend upon all of the following items.

- The number and costs of luxury heavy vehicles.
- The amount of reduced depreciation and expense deductions that would have been allowable under current law.
- The amount of tax decreases resulting from the resale of luxury heavy vehicles at higher cost basis.
- The amount of qualified tuition and fees paid during the taxable year imposed by the CSU or UC for enrollment in courses.
- The average adjusted gross income of taxpayers
- The number of taxpayers claiming the tuition and fees credit.
- The average applied credit against tax liabilities.

For purposes of this analysis, information obtained from a report released by US Public Interest Research Group in 1999 was used. In addition, the following assumptions were made:

(1) Assumed that approximately 50% of large luxury heavy vehicles sold or leased currently are allowed some sort of deduction. Of these vehicles it is estimated that approximately 20% qualify for both operating lease deductions and depreciation deductions.
(2) The average annual deduction per vehicle is $5,000 (reflecting the prevalence of three-year leases and that individuals may not use these vehicles 100% for business).
(3) The average write-off period for these vehicles is three years.
(4) The business use of leased luxury heavy vehicles would decline by 15% annually as a result of this bill.
(5) The average marginal tax rate of 6% was used.

Luxury Heavy Vehicle Deductions

To arrive at the estimate, it was determined from the US Public Interest Research Group's report that approximately 760,000 qualifying vehicles would be sold or leased in the United States in 2004. Of this total it is estimated that 11% would be located in California (84,000).

Assuming 60% of the vehicles would no longer receive an average deduction of $5,000, disallowed deductions would amount to approximately $250 million for vehicles purchased or leased in 2005. Assuming an average marginal tax rate of 6% the first year, revenue gain is estimated to be approximately $15 million (6% x $250 million = $15 million). The fiscal-year estimates above reflect changes in estimated tax and final tax payments. That is, it was assumed that approximately one third of the $15 million first-year revenue gain would be reflected in increased estimate payments in the 2004-05 fiscal year resulting in the $5 million estimate for that fiscal year.

The projected impact for LHV deductions reflects the timing of reduced deductions and, in future years, a decrease in gains realized from the sale of these vehicles due to an unreduced basis under the bill. The revenue gain peaks in 2006-07 due to a build up of reduced depreciation deductions. That is, in 2006-07, deductions are reduced for vehicles placed in service in 2004, 2005, and for 2006. The impact begins to decrease in 2007-08 because vehicles placed in service in 2004 would otherwise have been fully depreciated; therefore, reduced deductions begin to taper off. Also, sales of vehicles placed in service in 2004 begin to occur resulting in either reduced gains or actual losses. Credits, however, exhibit a different fiscal-year pattern as discussed below.

Tuition and Fees Applied Credits

Based on information from the California Statistical Abstract for 2003 there are approximately 477,500 full-time and 131,000 part-time students enrolled in the CSU and UC 2002. Based on this information it is estimated that the average composite tuition fee for all full-time students enrolled in both universities is approximately $4,700 and $3,200 for a qualifying part-time student. This estimate assumes 50% of students enrolled part-time would be carrying a course load of at least one-half of that of a full-time student. This yields tuition fees of approximately $2.2 billion for full-time and $200 million for part-time enrolled students for a total of $2.4 billion in total tuition fees for 2002. This amount was grown to approximate 2005 and beyond or an estimated $2.8 billion.

Based on the department's Personal Income Tax model, it is estimated that only 44% of fees would quality for the 2% tax credit, due to income limitations and the average tax liabilities of qualified taxpayers. This yields approximately $25 million annually in potential applied credits ($2.8 billion x 44% x 2% = $25 million).

The fiscal year cash flow patterns reflect applied credits in the respective years and are based on an analysis of how taxpayers adjust their tax payments to reflect a change in liability resulting from current law. That is, prior fiscal year estimated tax payments are not typically adjusted to take into account the availability of the credit but instead, because of the carryover, the application of the credit is reflected in the succeeding fiscal year. Thus, applied credits reflect not only the credits allocated in the year, but may reflect carryover of unapplied credits from prior fiscal years.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
john.pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov